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Supreme Court of the United States

October Term, 1938

No. 98

M. E. Blatt Company, *Petitioner*,

v.

The United States.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR PETITIONER.

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OPINION BELOW.

The opinion of the Court of Claims (R. 9-14) is reported in 23 Fed. Supp. 461.

JURISDICTION.

Final judgment was entered in the Court of Claims on May 31, 1938 (R. 14). The petition for certiorari was filed on June 7, 1938 (R. 14) under Section 3 (b) of the Act of February 13, 1925, 43 Stat. 939, and was granted on October 10, 1938.

STATEMENT OF THE CASE.

1. Question Presented.

The question presented is whether improvements made by a lessee of real estate, which become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor, either (1) to the extent of the fair market value thereof at the time of completion of the improvements, subject to the lease; or (2) to the extent of an aliquot part of the estimated depreciated value thereof at the expiration of the lease, applied to each year of the lease.

2. The Facts of the Case.

The additional tax in dispute, recovery of which is sought by petitioner, is for petitioner's fiscal and taxable year ended January 31, 1932, and results from the inclusion in gross income for that year of an item of $1,742.31 determined as follows:

Shortly before the beginning of the taxable year, petitioner leased certain real estate to Ventnor Realty & Leasing Company for a term of ten years, for a moving picture theatre. As a part of the agreement the lessor undertook to make certain alterations and improvements, and the lessee undertook to install moving picture and talking apparatus, theatre seats, and other fixtures, furniture and equipment necessary for the operation of a theatre. The lease expressly provided that all such fixtures, furniture and equipment "shall at the expiration or other sooner determination of this lease become the property of the landlord." (R. 6-7.)

In accordance with the agreement of the parties, the improvements were made, at a cost of $114,468.77 of which the lessee paid $40,674.30, as set out in the findings of fact (R. 8).

Upon the audit of petitioner's income tax return for the taxable year in question, the Commissioner of Internal Revenue determined that the depreciated value—at the end of the term of the lease—of the improvements for which the lessee had paid $40,674.30, would be $17,423.14, and that the latter amount should be spread over the term of the lease and an aliquot part thereof, *i. e.* one-tenth or $1,742.31, treated as income to the lessor for each year of the term, beginning with the taxable year ended January 31, 1932 (R. 6, 8).

The inclusion of $1,742.31, as stated, in petitioner's gross income for the taxable year in question, resulted in an additional tax of $211.61 which was duly paid (R. 8). Thereafter, a timely claim for refund was filed and was disallowed (R. 9) and this suit was commenced in the Court of Claims (R. 1).

3. Statutes and Regulations Involved.

Section 22 of the Revenue Act of 1932, c. 209, 47 Stat. 169:

> "(a) General definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

> "Art. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

* * * * * * * * *[1]

4. History of the Regulations.

The general question here involved, whether the value of improvements made by a lessee may be treated as income to the lessor prior to sale or other disposition of the property, is one which has caused difficulty for many years and has been the subject of considerable discussion[2] and some difference of opinion in the courts.

None of the revenue acts, from 1913 to 1938, contains any specific authority for the regulations which provide for the inclusion in gross income of such supposed gains. The regulations rest solely on the general definition of gross income, in every revenue act, as including "gains or profits and income derived from any source whatever."

The first regulations dealing with this question were Regulations 33, under the 1916 Act, based on T. D. 2442, dated February 6, 1917, to the effect that "when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the

[1] The remainder of Art. 63 of Regulations 77 deals with cases where the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease.

[2] The Tax Magazine, October 1938, p. 577; 20 Minnesota Law Review, 320; 30 Illinois Law Review, 392; 47 Harvard Law Review, 1268; 51 Harvard Law Review, 1113; 98 American Law Reports, 1207; Paul & Mertens, *Law of Federal Income Taxation,* Vol. 1, sec. 10.12, and 1937 Supplement; Roswell Magill, *Taxable Income,* pp. 20, 103, 205.

lease term is gain or profit to the lessor *at the end of the lease term* and is to be accounted for as income at that time."

In 1919, in *Miller* v. *Gearin,* 258 Fed. 225, this regulation was held invalid by the 9th Circuit Court of Appeals. In that case the property had been leased by the owner in 1907 pursuant to an agreement whereby the lessee erected a building. On the lessee's default in 1916 the owner took back the property. The Treasury taxed the owner on the increased value of his property, as income realized in 1916. The Court said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was not a gain, but was a loss. Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years. The lease provided that the ownership of all buildings or improvements put upon the premises was to vest in the lessor immediately upon the construction of the same, subject to the provisions of the lease."

Certiorari to review *Miller* v. *Gearin* was sought by the Treasury but was denied, 250 U. S. 667.

Thereupon, the Treasury changed the regulations to provide that the gain or income to the lessor resulting from the making of improvements by a lessee would be treated as derived by the lessor "at the time when such buildings or improvements are completed." T. D. 3062, 3 Cum. Bull. 109. This change was incorporated in Regulations 45 (1920 edition), under the 1918 Act, as follows:

> "When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not

subject to removal by the lessee, the lessor receives income at the time such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease."

Again, in 1922, the regulations were amended to provide for the alternative treatment whereby the estimated depreciated value of the improvements might be spread over the life of the lease and an aliquot part thereof reported as income for each year of the lease. Regulations 62, Article 48, under the 1921 Act.

Thereafter, until the regulations promulgated under the 1934 Act, there was no substantial change. Article 63 of Regulations 77, under the 1932 Act, here involved, is quoted above at page 3.

Article 22 (a)-13 of Regulations 86, under the 1934 Act, for the first time eliminated the words "in pursuance of an agreement with the lessor" contained in the prior regulations, thus making it immaterial whether the improvements were optional or required.

5. Decisions of the Courts.

The earliest decision on this question, *Miller* v. *Gearin*, 258 Fed. 225, is mentioned above. To the same effect is *Cryan* v. *Wardell*, 263 Fed. 248, in the District Court for the Northern District of California.

Other cases which indirectly or by way of dictum lend support to the Treasury regulations are *United States* v. *Boston & Providence R. R. Corp.*, 37 Fed. (2d) 670, and *Crane* v. *Commissioner*, 68 Fed. (2d) 640, both in the First Circuit Court of Appeals.[3]

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[3] In *Kentucky Block Coal Co.* v. *Lucas*, 4 Fed. Supp. 266, the District Court for the Western District of Kentucky held that the value of repairs and additions made by a lessee and which became a part of the lessor's realty when made, was taxable income to the lessor in the year in which made, but the court did not refer to any of the regulations or to any other decisions.

Cases in which the regulations have been directly upheld are *Campbell* v. *United States*, 384 C. C. H. 9408, in the District Court for the Territory of Hawaii, and the instant case now under review.

In the following cases, on the other hand, the regulations have been held to be invalid, in that they attempt to tax as income that which is not realized gain or income in a constitutional sense: *Hewitt Realty Co.* v. *Commissioner*, 76 Fed. (2d) 880, in the 2nd Circuit Court of Appeals; *Hilgenberg* v. *United States*, 21 Fed. Supp. 453, in the District Court for the District of Maryland; *Staples* v. *United States*, 21 Fed. Supp. 737, in the District Court for the Eastern District of Pennsylvania; *English* v. *Bitgood*, 21 Fed. Supp. 641, in the District Court for the District of Connecticut; *Dominick* v. *United States*, 384 C. C. H. 9418, in the District Court for the Southern District of New York; and *Fifteenth St. Investment Co.* v. *Nicholas*, 23 Fed. Supp. 863, in the District Court for the District of Colorado.

SPECIFICATION OF ERRORS.

The court below erred in holding, on the facts found, that the item of $1,742.31 in question constituted "income" to petitioner for the taxable year ended January 31, 1932, and in denying to petitioner a judgment for the recovery of the additional tax paid on account thereof.

ARGUMENT.

I. When improvements are made by a lessee, as in the instant case, there is no realization of gain by the lessor at the time the improvements are completed.

The Treasury regulations, and the action of the Commissioner in the instant case, are founded on the assumption that there is a *realization* of gain by the lessor *at the time the improvements are completed.* The whole case rests on that assumption. If there is no realization of gain by the lessor at the time the improvements are completed, there is

no "income" in the sense of the Sixteenth Amendment or in the sense of the statute.

It is settled and needs no argument that the Commissioner cannot by regulations make income of that which is not income in the constitutional sense. Nor can any long continued administrative interpretation, or the enactment of subsequent revenue acts by Congress impliedly approving such administrative interpretation, accomplish the same result. *Manhattan General Equipment Co.* v. *Commissioner,* 297 U. S. 129; *Koshland* v. *Helvering,* 298 U. S. 441.

The question here, however, does not go to the constitutionality of the statute. The statute does not specifically tax as income the "gain" which the Commissioner has taxed to petitioner in the instant case. The statute taxes "gains or profits and income derived from any source whatever." If the Commissioner's regulations on this question go too far, it follows that he has misconstrued the statute.

On what theory, then, does the Government contend that when improvements are made by a lessee there is a realization of gain by the lessor at the time the improvements are completed?

It is, as we understand it, the theory that upon the completion of the improvements there is an immediate accession of value to the lessor's property which is the equivalent of cash, in that (1) it can be measured by depreciation over the life of the lease, and (2) it can be converted into cash by selling the property subject to the lease. This theory is stated by the court below (R. 10) as follows:

> "Improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitute compensation paid by the lessee as additional rental for the use of the leased premises. This compensation is a fixed, definite, and ascertainable amount under the contract. The cost of improvements less depreciation over the term of the lease is a fair measure of their present worth to the lessor as rental for the leased premises in addition to the stipulated money payments to be made by the lessee, and

this amount may, we think, be properly regarded as a gain, profit, or income to the lessor under the Sixteenth Amendment and the statutory definition of taxable income. Such amount is not an indefinite element similar to natural appreciation in market value of property owned by a taxpayer or appreciation in value through capital improvements made by the owner of the property which need some form of measurement, such as a sale, to be rendered definitely known and ascertainable in amount. A lessor has the unrestricted ownership of the leased premises, although, as a result of the lease, he is deprived of the beneficial use of the leased premises, and, therefore, of the beneficial use of the gains accruing to him through improvements constructed by the lessee, but we think it is clear that under the statute the gain, profit, or income is not divested of its character, as such, by the lease arrangement which may limit, for a time, its use or disposal by the taxpayer or which may entirely deprive the lessor for the period stated in the lease of the beneficial use of the gain. * * * The lessor is free to sell or otherwise dispose of the improvements subject to the lease."

A. The Theory on Which the Decision of the Court Below is Based is Fundamentally Unsound for Several Reasons.

1. *It ignores the fact that in the instant case, and in other similar cases caught in the net of the regulations, the supposed gain to the lessor is in no sense additional rental for the use of the premises.*

The provision of the lease in the instant case bearing on this question is quoted in the findings of fact (R. 7) as follows:

"5. It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accomodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties

> hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord."

Thus, the tenant agreed to paint and decorate (provided the landlord would pay $1,500 of the cost) and to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre. That was all. The tenant was not required to spend any certain amount. The amount was left entirely to his discretion and self-interest. He had a lease for ten years and presumably would spend as much on improvements as would fit the premises for his purpose, but he was not required to spend any amount whatever *for the benefit of the lessor*. So far as the lease went, his expenditures might well be limited to improvements which would have a life not exceeding the term of the lease. If he spent more and the improvements he made were of such a character as would carry over some residual value beyond the term of the lease, any such excess value would be a gift to the lessor. At all events it was not required by the terms of the lease.

The common definition of rent or rental is an agreed fixed payment for the use of property. It need not necessarily be payable in money but it must be agreed upon and it must be fixed in amount or quantity.

In *Duffy* v. *Central Railroad Company of New Jersey*, 268 U. S. 55, 63, an income tax case involving among other questions whether expenditures made by a long-term lessee for additions and betterments, as required by the terms of

the lease, could be treated as "additional rentals" for the use of the property, this court said:

> "The term 'rentals', since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property. *Dodge* v. *Hogan*, 19 R. I. 4, 11; 2 Washburn, Real Property (6th ed.) 1187; and in that sense it does not include payments, uncertain both as to amount and time, made for the cost of improvements or even for taxes."

It seems clear, therefore, that whatever else it may be called, any future residual value in the improvements in question in the instant case, estimated as at the end of the term of the lease, cannot properly be regarded as additional rental to the landlord.

2. *It ignores the fundamental rule of income taxation laid down in Eisner* v. *Macomber, that to constitute taxable gain or income there must be a realization, either by severance from the source or by conversion of both source and gain into a different form, and that unrealized appreciation in value is not taxable as income.*

The general rule laid down in *Eisner* v. *Macomber*, 252 U. S. 189, has been established for nearly two decades. The reasoning on which the rule is based is clearly stated in the opinion, at page 207, where the court, after quoting the definition of income given in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, and *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185,[4] said:

> "The Government, although basing its argument on the definition as quoted, placed chief emphasis upon the word 'gain', which was extended to include a variety of meanings; while the significance of the next

[4] "Income may be defined as the gain derived from capital, from labor, or from both combined."

three words was either overlooked or misconceived. *'Derived - from - capital'*; - 'the *gain - derived - from - capital'* etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." (Italics as in Opinion)

The requirement of realization, thus laid down in *Eisner* v. *Macomber*, is still a fundamental rule of income taxation. As recently as 1936, in *United States* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, 99, this court has said:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition."

Compare also *Koshland* v. *Helvering*, 298 U. S. 441; *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417; *MacLaughlin* v. *Alliance Insurance Co.*, 286 U. S. 244; *Burnet* v. *Logan*, 283 U. S. 404.

What bearing has this requirement of realization on the instant case, and has the court below taken it sufficiently into consideration?

Here the petitioner is the owner of property which it has leased to another for ten years. The lessee of the property has added improvements which the Commissioner has found will have a residual value of $17,423.14 at the end of the term of the lease. The value of petitioner's property, therefore, has been increased and a part of that increased value will presumably still be in the property when it reverts to petitioner upon the termination of the lease. Has petitioner realized any immediate gain by virtue of all this? Certainly there has been nothing "severed" from the property (petitioner's capital) or "received or drawn" by petitioner for its "separate use, benefit and disposal." There

has been no gain or profit in the sense of "something of exchangeable value proceeding from the property." Petitioner has no control over the property, or the improvements, so long as the lease runs. Even when the lease ends, petitioner will have only the possession of real estate bearing improvements which fit it for use as a theatre.

The court below suggests, however, that petitioner has at all times a right to sell the property subject to the lease, and so immediately realize the cash value of the improvements to the extent that they will have value beyond the term of the lease. This does not aid the court's conclusion. On the contrary, it supports petitioner's argument that there is no realization of gain *at the time the improvements are added,* and that the realization of gain, if any,—and the taxation thereof as income—can only take place upon the sale or other disposition of the property.

The point is well stated in the majority opinion of the Circuit Court of Appeals, 2nd Circuit, in *Hewitt Realty Co. v. Commissioner,* 76 Fed. (2d) 880:

> "While the term lasts, the lessor receives nothing which benefits him but the rent; when it ends, he gets land for which he can get a higher rent—that is, if the building is neither outworn, nor outmoded. On all rents he must pay a tax. If he sells at any time, pending the term or after it ends, the building will increase his gain; and his taxes in proportion."

3. The decision of the court below ignores the practical difficulties and realities of the situation.

It seems fairly obvious that the regulations in question which tax as income to the lessor, either immediately or by spreading it over the term of the lease, the "estimated depreciated value" at the end of the lease of any improvements made by the lessee, are bound to be uncertain and difficult of application in particular cases.

These difficulties are set out so clearly in the dissenting opinion of a minority of the Board of Tax Appeals in

Morphy v. *Commissioner*, 35 B. T. A. 289; that the opinion is worth quoting:

"Arundell, dissenting: It seems to me that the decision of the Second Circuit in the *Hewitt Realty* case, 76 Fed. (2d) 880, gives a sound solution to the question here involved. The substance of the holding in that case is that the erection of a building by a lessee does not result in realization of income to the lessor; the realization of income, if any, occurs when the lessor sells. This view, as stated by Judge Learned Hand, author of the majority opinion, 'answers every fiscal necessity far more directly and simply than any other formula.'

"The lease in the instant case was for a period of over thirty years. Under the view expressed in the Commissioner's regulations and approved by the majority opinion, it is necessary to look into the future to the time when the lease terminates and determine the value of the building after taking into account the ravages of time. In many cases of long-term leases the original term extends beyond the useful life of the improvements. Some of them involve definite provisions for renewal. There are always the possibilities of termination prior to the expiration of the agreed term, and accelerated depreciation and obsolescence resulting from causes unforseeable when the lease is executed. These are factors that complicate any attempted application of the Commissioner's regulations. But what is more serious, they show the impossibility of determining with any fair certainty the amount to be treated under the regulations as realized income. A promise to turn over possession of a building many years hence, and subject to the many contingencies necessarily involved in any transaction extending over a period of years, does not seem to be in any proper sense the present equivalent of cash. Cf. *Burnet* v. *Logan*, 283 U. S. 404. The difficulty of determining as a matter of fact the value of improvements is recognized in both opinions filed in the *Hewitt* case. The majority opinion obviates the difficulty and offers a sound solution. It treats as income the full amount eventually realized when it is actually realized. Any-

thing short of this does not meet the test of realized income with which the taxing act is concerned. For these reasons, I think we should adopt the principle of the *Hewitt Realty* case and decline to follow the earlier cases that hold otherwise."

In the above cited case, *Morphy* v. *Commissioner,* 35 B. T. A. 289, and in *Sloan* v. *Commissioner,* 36 B. T. A. 370, the majority of the Board of Tax Appeals declined to follow the decision of the 2nd Circuit Court of Appeals in *Hewitt Realty Co.* v. *Commissioner,* 76 Fed. (2d) 880, and continued to uphold the regulations.

However, in a subsequent case, *Hart* v. *Commissioner,* 37 B. T. A. 360, which involved a lease containing a renewal option, the Board recognized the difficulty in applying the regulations to such cases and held that where the creation of one renewal term of the lease would put the date of the expiration of the lease beyond the depreciated life of the building, and where the option to renew did not involve any increase in rent due to the erection of the building, it cannot be said that the lessor realized any taxable income upon the making of the improvements, and that the questions when and whether taxable income is realized cannot be determined until the time when the lessee elects whether to renew or not.

The *Hart* case illustrates one of the situations where practical difficulties, as pointed out in the dissenting opinion in the *Morphy* case, will prevent the uniform application of the regulations as they stand.

The following paragraph from Paul & Mertens, *Law of Federal Income Taxation,* Vol. 1, sec. 10.12, 1937 Supplement, referring to the decision of the 2nd Circuit Court of Appeals in *Hewitt Realty Co.* v. *Commissioner,* may also be quoted:

"This decision, if allowed to stand, will go far to remedy a situation full of at least potential injustice. The lessor has no realized income from the 'acquisition' of such buildings, in the sense of money from

which a share may, without hardship, be devoted to the support of government. He has nothing with, or from which, to pay taxes. His income is in property which he cannot sell, and the majority opinion in its recognition of such practical considerations lays down the broad doctrine that in such cases the government should be content to wait for its taxes, as the taxpayer perforce must wait for his income, until there is a conversion into cash or its real equivalent."

In the instant case, it may also be noted that petitioner is a corporation subject to the tax on undistributed profits imposed by the Revenue Act of 1936, applicable to the years 1936 and 1937, and to some extent continued by the Revenue Act of 1938. The undistributed profits tax is a graduated tax, in effect a penalty tax, intended to force the distribution of corporate earnings or profits—that is to say, income. If the "income" which the Government has charged to petitioner here, not only for the taxable year actually involved in this case but likewise for every year of the lease in question, is in fact and in law income to petitioner as the Government contends, it becomes a problem to determine how it can be distributed so as to avoid the tax on undistributed profits.

II. When improvements are made by a lessee, as in the instant case, the accession of value to the property is not income but a capital addition.

As pointed out above, page 10, the lessee in the instant case was not required by the terms of the lease to spend any certain amount on improvements *for the benefit of the lessor*. All that the lessee agreed to do was to install proper fixtures and equipment for the operation of a theatre, which was the purpose for which he leased the property for a term of ten years. If the lessee made improvements so extensive that they would have a value beyond the term of the lease, as has been found, of course they would become the property of the landlord at the end of the term. To the ex-

tent of the value thereof at the end of the term, the improvements would appear to be a gift—or contribution to the landlord's capital.

Gifts have been expressly exempted in all the revenue acts beginning with the 1913 Act. Section 22 (b) (3) of the 1932 Act, which is the act here involved, provides:

> "(b) The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> * * *
>
> (3) Gifts, bequests, and devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);"

It follows that whatever increased value the lessor's property in this case may have, the added value is a capital addition and is not income.

On this ground, business subsidies have consistently been held not taxable as income to the recipient. The value of property conveyed to a company by business men or a chamber of commerce to induce it to locate its business on the property, is not taxable as income to the company. *Holton & Co.* v. *Commissioner*, 10 B. T. A. 1317. Similarly, where pursuant to contract, property was conveyed to a company when its pay-roll reached a certain amount. G. C. M. 16952, Cum. Bull. 1937-1, p. 133. Contributions to a railroad company for the construction of spur tracks or for other construction work are not taxable income. *Texas & Pacific Ry. Co.* v. *United States*, 72 Ct. Cls. 629, 52 Fed. (2d) 1040; affirmed on another issue, 286 U. S. 528. *Southern Ry. Co.* v. *Commissioner*, 27 B. T. A. 673; reviewed on other issues, 74 Fed. (2d) 887. *Baltimore & Ohio R. R. Co.* v. *Commissioner*, 30 B. T. A. 194.

Edwards v. *Cuba Railroad Co.*, 268 U. S. 628, involved the same question with respect to government subsidies. There the Cuba Railroad Company, a New Jersey corpora-

tion, was shown to have received from the Republic of Cuba from 1911 to 1916 large subsidies in cash, and certain land, buildings and equipment, all in aid of the construction of lines of railroad in Cuba. The Commissioner taxed the Company on the subsidy payments made in 1911 and 1912 under the Corporation Excise Tax Law of August 5, 1909, on the payments made in 1913, 1914 and 1915 under the Income Tax Law of October 3, 1913, and on the payments made in 1916 under the Revenue Act of 1916, as income. No attempt, however, was made to tax the land and other physical property turned over to the company. This court held that both the land and other physical property and the cash subsidies were equally contributions to capital and that the cash subsidies did not constitute income within the meaning of the Sixteenth Amendment, the opinion concluding as follows:

> "All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income. Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment."

Generally with respect to gifts, it may also be noted that under the earlier revenue acts, until 1921, the basis for determining the gain or loss to the donee upon a sale of donated property was its fair market value at the time of acquisition, *i. e.* the date of the gift. In 1921, to stop the practice of defeating, by means of a gift, the potential income tax on the sale of property having an appreciated value, Congress provided that the basis for determining gain or loss on the disposal of property acquired by gift after De-

cember 31, 1920, should be the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift. The validity of this original basis provision was upheld by this court in *Taft* v. *Bowers*, 278 U. S. 470, broadly on the ground that the statutory provision was a proper method for obtaining the income tax on the true appreciation in value of a capital asset after the date of realization.

Under the reasoning of *Taft* v. *Bowers*, it has been assumed that the gift itself could not be treated as taxable income when received by a donee, because income has not yet been realized by severance from capital, but that when the donee disposes of the donated property, so that a realization in the technical sense occurs, it is proper to determine to what extent the donated property represents transmitted capital and to what extent income. Roswell Magill, *Taxable Income*, pp. 358-367.

An analogy may also be found in the case of a bargain purchase of property, as for example where an employee of a corporation purchases stock of the corporation at less than its fair market value. The Commissioner has held, I. T. 3204, Int. Rev. Bulletin No. 29, July 18, 1938, that in such cases the employee receives additional compensation upon the acquisition of the stock to the extent of the difference between the amount he pays and the fair market value of the stock when issued to him. The Board of Tax Appeals and the courts, however, have not agreed with the Commissioner's theory of realization and have held that, unless there is clear evidence that the difference in value is intended as additional compensation, there is no realization of income upon the acquisition of the stock by the employee and that the gain, if any, is realized upon the sale or other disposition of the stock. *Geeseman* v. *Commissioner*, 38 B. T. A.—No. 37; *Omaha National Bank* v. *Commissioner*, 75 Fed. (2d) 434; *Rossheim* v. *Commissioner*, 92 Fed. (2d) 247.

III. The authorities cited in support of the conclusions reached by the court below are inapplicable.

The court below cites in support of its conclusions on the issue here involved, as quoted above, page 8, *Poe* v. *Seaborn,* 282 U. S. 101, *Lucas* v. *Earl,* 281 U. S. 111, and a number of cases in the several circuit courts of appeals.

The cases cited are obviously inapplicable. *Poe* v. *Seaborn* involved the question whether a husband and wife, residents of the State of Washington, where the community property system prevails, could split their joint income, including the husband's salary, and file separate returns, or whether the husband could be required to file one return and include therein all income. *Lucas* v. *Earl* involved an arrangement whereby a husband and wife contracted that all property which they might thereafter acquire in any way, either by earnings or otherwise, should be treated and considered as owned jointly, and the question was whether the husband's earnings thereafter were taxable to him. In each case the question was one of tax liability, as between two individuals, on what was admittedly income, not as to whether there was income. Here the question is more fundamental—whether there is in fact any income realized.

On the specific issue here involved, *Miller* v. *Gearin,* 258 Fed. 225, has already been mentioned, *supra,* page 5. *Miller* v. *Gearin* has been assumed to be authority for the proposition that a lessor may be taxed on the value of improvements added to real estate by the lessee thereof, as income realized by the lessor *at the time the improvements are added.* This assumption has been made by the Commissioner, by the Board of Tax Appeals, and by the court below in the instant case. The error in this respect and the misconception of the decision in *Miller* v. *Gearin* has been pointed out clearly in the opinions in the recent cases on the other side of this question, particularly in *Hewitt Realty Co.* v. *Commissioner,* 76 Fed. (2d) 880, *Hilgenberg* v. *United States,* 21 Fed. Supp. 453, and *Staples* v. *United States,* 21

Fed. Supp. 737. On this point in the *Hilgenberg* case the court said:

> "The theory underlying the present attitude of the Commissioner and all of the decisions of the Board of Tax Appeals appears to be founded on the misconception that since the value of the improvements is not income at the time the lease is terminated, it must of necessity be income when they are completed. This, of course, is a *non-sequitur*, because it need not be income at either time. * * * In so far as the decision in the *Miller* case, or in any other case referred to, is to be considered as a holding to this effect, we must disagree with such holding, because we believe that the conclusion, and the reasoning upon which such conclusion is based, in the *Hewitt Realty Company* case, *supra*, are more sound."

United States v. *Boston & Providence R. R. Corp.*, 37 Fed. (2d) 670, involved the question whether under the Revenue Act of 1918, which in the case of corporations required a determination of "invested capital" for the purpose of the excess profits tax thereby imposed, the earned surplus of a lessor railroad corporation should include the value of the obligation of its lessee to pay the principal and interest of the lessor's indebtedness. The particular facts were that the Boston & Providence R. R. Corporation, owner of a railroad between Boston and Providence, leased its road for ninety-nine years to the Old Colony R. R. Company, upon the undertaking of the latter to pay an annual rental of $900,000 a year, plus the expenses necessary to keep the corporate organization of the lessor alive, to pay all taxes and other assessments, to pay the lessor $1,300,000 in cash, and to create a sinking fund into which annual payments would be made by the lessee corporation sufficient to discharge, before the expiration of the lease, the funded and floating debt of the lessor, which amounted at that time to $2,170,000. The lessee also covenanted to apply the sinking fund in discharge of the lessor's indebtedness and to pay any deficiency. In 1893 the Old Colony assigned the

lease to the New York, New Haven & Hartford R. R. Company, which assumed the obligation in the lease to establish a sinking fund for the liquidation of the funded debt of the Boston & Providence. Until 1918 the lessor corporation had not carried on its books as an asset any item representing the obligation of its lessee to pay its funded debt. The question presented for decision was whether the lessor corporation's "invested capital" for 1918, for the purpose of the excess profits tax, should be increased by the cash value of the agreement of the lessee to pay its funded debt. The court held that it should be so increased, on the ground that the agreement to discharge the funded debt of the lessor should be treated as income received when the lease was originally made, and not having been distributed had become a part of the lessor's "undivided profits" or "earned surplus" and so a part of "invested capital" as defined in the statute. In reaching the conclusion stated, the court cited and relied on *Miller* v. *Gearin* as authority for the proposition that a building erected on leased land, under a covenant that it shall become and remain a part of the realty and the property of the lessor, is income to the lessor to the extent that it has enhanced the value of the lessor's property, and the fair market value thus added to the lessor's property is taxable to the lessor in the year in which the building is constructed.

In *Crane* v. *Commissioner*, 68 Fed. (2d) 640, the question was whether, where improvements were made by a lessee which were never reported as income by the lessor, the value of such improvements could be added to the basis for determining gain on the sale of the property by the lessor. The court held that the value of the improvements could not be so added to the basis, on the ground that under the regulations the value of the improvements should have been returned as income by the lessor at the time the improvements were completed, citing *Miller* v. *Gearin* and *United States* v. *Boston & Providence R. R. Corp.*, and that the statute and regulations "should not be construed to entitle

a taxpayer to the benefit of an expenditure made by his lessee, when the taxpayer has failed to report or to pay a tax in the proper year or years upon the income received by virtue of the lessee's expenditure.

In none of the cases cited, either *Miller* v. *Gearin* or *United States* v. *Boston & Providence R. R. Corp.* or *Crane* v. *Commissioner*, was the question here presented directly involved or fairly considered.

The court below (R. 13), and the Government in opposing certiorari in the instant case, also call attention to the fact that the position of the Treasury Department on the question here presented was taken as early as 1920 in the adoption of T. D. 3062 amending Article 48 of Regulations 45, and has presumably been approved by Congress as evidenced by the enactment of subsequent revenue acts without any reference to the regulations or rulings of the Treasury Department on this question.

The answer is obvious. No long continued administrative interpretation, or the enactment of subsequent revenue acts by Congress impliedly approving such administrative interpretation, can make income of that which is not income in the sense of the Sixteenth Amendment. *Koshland* v. *Helvering*, 298 U. S. 441. The constitutional question, whether there is income in the sense of the Sixteenth Amendment, must always be open.

But here, it may be said, the question is the construction of the statute, not its constitutionality, as stated at the beginning of this argument; *supra*, page 8. The Government made the same point, in effect, in *Towne* v. *Eisner*, 245 U. S. 418, moving to dismiss the writ of error for want of jurisdiction, on the ground that the only question involved was the construction of the statute, not its constitutionality. On this objection, the court by Justice Holmes said:

> "Whatever the meaning of the Constitution, the Government had applied its force to the plaintiff, on the assertion that the statute authorized it to do so, before the suit was brought, and the court below has

sanctioned its course. The plaintiff says that the
ute as it is construed and administered is uncons
tional. He is not to be defeated by the reply tha
Government does not adhere to the constructio
virtue of which alone it has taken and keeps the p
tiff's money, if this court should think that the
struction would make the act unconstitutional. W
it keeps the money it opens the question whether
act construed as it has construed it can be m
tained."

Respectfully submitted,

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